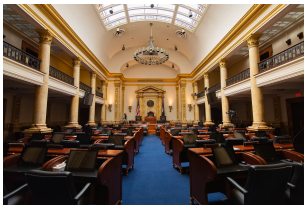

Kentucky Tax Talk: Unpacking The 2022 Legislative Session

May 18, 2022

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Tax Law Defined™ Blog

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This article was originally published in Law360 Tax Authority.

Prior to the 2022 Kentucky legislative session, many anticipated major tax reform to be a priority for the General Assembly. As the 2020 and 2021 regular sessions became dedicated to COVID-19 legislative action or cleanup, it would be the first time in two years tax reform had a shot of being enacted. While the General Assembly achieved some of its tax reform goals, many items came out differently than expected. Other items will be tried again next year or in 2024. Leading up to the start of the session, the Tax Foundation, sponsored by the Kentucky Chamber of Commerce, published a report analyzing several taxes that could be altered, eliminated or improved to modernize the state's tax policies. Some changes that were discussed in the report, and that were anticipated to be included in legislation during the session, included:

- A general shift to reliance on consumption-based taxes — as opposed to production-based taxes — by phasing out the income tax and expanding the sales and use tax;
- Flexibility and expansion of local taxes to authorize localities to impose a local sales tax, and;
- Reform of the Kentucky inventory tax on barreled bourbon, either through repeal or allowing the inventory tax credit to be refundable or carried forward.

Ultimately, the report served as a decent tax reform guide as several of the items it included ended up in various legislation. However, some items, such as the inventory tax, the General Assembly chose to leave alone. The most significant piece of tax reform legislation that successfully made its way through the regular session was House Bill 8. While H.B. 8 was a comprehensive tax reform bill including a variety of changes, a few items are exceptionally noteworthy.

Phaseout of Individual Income Tax

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Of most importance to many Kentuckians, H.B. 8 legislates a structure for a potential complete phaseout of the Kentucky individual income tax.

The original version of the bill proposed to cut the individual income tax rate from 5% to 4% beginning Jan. 1, 2023, with a phaseout provision that over time eliminated the individual income tax altogether. Still, some legislators worried that if a drop in rate happened automatically, Kentucky might mimic other states that unsuccessfully attempted similar initiatives without the proper safeguards in place. For example, aggressive tax cuts without efficient phaseout provisions that Kansas made in 2012 and 2013 damaged that state's economy. After several committee substitutes from the state House of Representatives and Senate, the legislation — as approved by both houses, vetoed by Gov. Andy Beshear and overridden by the General Assembly — ultimately maintains the income tax phaseout, but with some adjustments.

Unlike the original version of the bill, the legislation does not include the immediate drop-in rate from 5% to 4%. Instead, any reduction in rate must be triggered by certain revenue levels, although it is predicted that the state will meet the revenue expectations for the first two rate reductions by 2024. Every rate reduction will be 0.5%, dependent on the amount of funds in the state's budget reserve trust fund as well as the amount of general fund receipts that exceed appropriations in a fiscal year. This ensures that the state does not make too drastic a cut in income tax prior to assurance that the state's revenue levels can sustain its current spending, which would keep the commonwealth's credit ratings strong.

Another safeguard is that after 2023, rate reductions will not occur automatically once revenue triggers are met; rather, any reductions will require review and approval by the General Assembly. While it was anticipated that the corporate income tax rate might be reduced and the limited liability entity tax eliminated, no changes were made to either of these taxes. As the corporate income tax rate in Kentucky is already fairly competitive and many businesses' limited liability entity tax burden is minor compared to their corporate income tax burden, the lack of change to these taxes should not be a significant disadvantage to businesses.

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Sales Tax Base Expansion

In order to make up for the eventual elimination of the income tax, and to support the General Assembly's push for reliance on consumption-based taxes as opposed to production-based taxes, H.B. 8 also expands the sales tax base. Some were concerned that the General Assembly would raise the sales tax rate, or even allow for future local sales taxes. H.B. 8 instead expands Kentucky's 6% sales tax to include several new services, beyond those that became subject to sales and use tax after Kentucky's 2018 tax reform. Some examples of services that will now be expected to collect sales tax include utilities for nonprimary residences; transportation services such as taxis, car rentals, Uber and Lyft rides; lobbying services; marketing services; event and entertainment services; and prewritten computer software access services.

While the majority of these services should not bring substantial changes to Kentucky's business environment, the taxation of access to certain cloud-based services — e.g., software as a service, infrastructure as a service, platform as a service — could be a substantial issue for businesses to consider in Kentucky going forward. Uncertainty and controversy often follow taxation of technology-based services, as seen recently in nearby Tennessee. While the legislation provides that the tax only applies to included service providers with gross receipts greater than $6,000 in a calendar year, the above expansion of the sales tax base touches a wide variety of consumption. It is also noteworthy that services such as advertising, graphic design, boat docking and personal financial planning were included in the original version of the legislation, but were eliminated from its final version. This indicates that such services were at one point on the General Assembly's radar. Lobbying efforts seemingly removed these services for now, but if sales tax continues to expand, such services may be under fire again in later years.

Tax Amnesty Program

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Another significant tax reform item that passed this session was a tax amnesty program. While the amnesty provisions were originally included in a stand-alone bill, H.B. 176, the language of that bill was essentially included in H.B. 8. Importantly, unlike prior Kentucky tax amnesty programs, the new program, which is slated to run from Oct. 1 to Nov. 29, will use a third party to administer the program, unless the Kentucky Department of Revenue is unable to secure a successful bid. In that case the amnesty program will instead be administered by the department in 2023. The amnesty program is significant because historically it has been a large source of revenue; however, in the past the department strained to implement the program in such a short window of time while also managing other work flow.

The negative history of the state's ability to implement past amnesty programs is what lead to the third-party administration of the program. The amnesty program is significant for taxpayers in that it is a rare opportunity to clean up outstanding Kentucky tax issues with lowered or eliminated interest and penalties that for many nonfilers may be significant, depending on the number of years outstanding. The amnesty program will include most outstanding state tax liabilities — other than local taxes, such as real property tax — for tax periods beginning Oct. 1, 2011, through Dec. 1, 2021. Amnesty will apply to any nonfiler with outstanding tax liability in Kentucky, and taxpayers that have underreported their Kentucky taxes, unless there is an active criminal investigation pending by a state or federal agency.

What's Next

Despite the significant changes to — and potential full phaseout of — the personal income tax, the 2022 legislative session was rather anticlimactic. It does, however, set the stage for several other tax reform topics that legislators have hinted at being better timed for the next long — 60 day — session this year. These items include:

- Local option sales tax;
- Increased state sales tax;

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- Elimination or phaseout of Kentucky's barrel tax on aging distilled sports or the inventory tax; and
- Sports gaming and medicinal marijuana — which will have substantial tax revenue ramifications.

But we have heard that song and dance before. Many of these initiatives, such as passage of a tax on sports gaming and medical marijuana, have been teased by legislators for years, but have never made significant progress during a legislative session. Until then, we will continue reading the tea leaves to see what is in store for the continuing tax reform efforts to make Kentucky a more competitive place to live, work and do business. Individual Kentuckians will feel the changes made this legislative session as their paychecks become larger, while some purchases become more expensive from the addition of new sales tax. Some Kentucky businesses may be expected to collect sales tax for the first time because of the sales tax base. However, most Kentucky businesses were not significantly helped or hurt during the Kentucky session.

Regardless, legislative efforts this session made it clear that Kentucky is moving toward consumption tax reliance, with no sign of slowing down.

Please reach out to the authors, Mark Sommer, Daniel Mudd and Elizabeth Mosley, if you any questions pertaining to this article. You can also visit our Tax Law Defined Blog® to read about the latest developments in federal, state and local tax administration.

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